October 25, 2016

Hon. David Altmaier
Commissioner
Office of Insurance Regulation
J. Edmund Larson Building
200 East Gaines Street, Room 101A
Tallahassee, FL 32399-0305

Response to August 22, 2016 NAIC Staff Memo
On Group Capital Calculation

Dear Commissioner Altmeier:

The Property Casualty Insurers Association of America (PCI) appreciates the opportunity to answer the questions asked by the Group Capital Calculation (E) Working Group on the “inventory method” the Working Group intends to use. PCI is composed of nearly 1,000 member property/casualty insurance companies, representing the broadest cross section of insurers of any national trade association. PCI members write $202 billion in annual premium, 35 percent of the nation’s property/casualty insurance. Our response begins with general comments about the Group Capital Calculation project, and then addresses the Working Group’s questions.

**General comments**

The insurance regulatory landscape continues to evolve and this evolution includes a heightened focus on understanding the risks that a group could present to the solvency and soundness of regulated insurance companies. Although PCI continues to question the need for and propriety of a prescriptive group capital requirement, PCI recognizes that group capital standards have been implemented or are being developed by the Federal Reserve and various international insurance regulators.

PCI supports the NAIC’s efforts to develop a non-prescriptive group capital calculation tool that will allow the NAIC to more effectively understand and assess group risk and permit our time tested and proven U.S. state based insurance regulatory model to continue to serve as the most effective insurance regulatory system in the world. We believe the development of an effective and credible group capital assessment tool will enhance the primacy of state regulators’ roles as group-wide supervisors for U.S. groups and assist our domestic industry in avoiding intrusive group regulation by foreign insurance regulators.

We also strongly support the RBC Aggregation Approach as the proper basis for this tool. The state RBC framework is a proven and crisis-tested foundation. Broadly extending the RBC foundation beyond its current regulated insurer focus, however, is not a simple process. Any group capital system developed by the NAIC will inevitably be compared to the insurance group standards being developed by the Federal Reserve Board, the IAIS, and to Solvency II. It is therefore critical that the NAIC develop a robust, credible and defensible tool. The consequences of getting it wrong could be significant, misleading regulators, policyholders, investors and the public in general.

For this reason it is important to get it right first, rather than to develop a flawed tool and rely on improving it as time goes by. The Working Group should not tie itself to a specific artificial timetable that could cause hasty and inappropriate decisions. It is critical that any proposed NAIC group capital calculation be subjected to rigorous field testing prior to it being implemented. Such field testing will need to involve an iterative process and include a robust and transparent mechanism for regulators and industry to evaluate, adjust and modify the tool to avoid unintended consequences and unrecognized flaws.
Factor to be Used for Non-Insurance Entities Not Subject to Other Capital Requirements

Question 1: Is applying a flat charge to an entity’s BACV (book/adjusted carrying value) an appropriate approach for non-insurance entities that are not subject to other capital requirements? If the answer is no, please suggest an alternative approach, including why that approach is preferable to a flat charge.

No. Applying simple flat charges to an entity’s BACV is a flawed and overly simplistic approach that does little, if anything, to assess the actual risk that non-insurance entities held outside of regulated insurers may present to the insurance operations within a group. NAIC staff has already acknowledged that a flat charge approach lacks any risk sensitivity and we believe that such risk sensitivity must be a critical component of any credible group capital assessment tool.

A flat charge to BACV works effectively when applied to the subsidiary held by a regulated insurer under the current RBC framework because the NAIC is assessing the risk that the asset allowed as component of surplus will be available to pay policyholder claims. If the value of that asset decreases over time, less reliance is placed on the asset to meet policyholder claims and state regulators have rigorous tools in place that would limit the ability of the insurer to contribute additional capital or provide guaranties to support a failing or distressed subsidiary.

A group capital tool when applied to entities within the group that are not subsidiaries of an insurer needs to evaluate a qualitatively different risk. The affiliated entities are not being relied upon to pay policyholder claims. Instead, the NAIC needs to evaluate the risk that the affiliated entity presents to the parent holding company and to the insurance operations. A flat charge applied to an entity’s BACV is flawed because it would have likely result in lower capital charges for entities that are thinly capitalized and higher capital charges for healthy entities that are well capitalized and hold substantial equity. On balance, we would generally expect that a well-capitalized entity would be in a better position to absorb risk, while a thinly capitalized entity would be more risky to the group, rather than less risky. The flat BACV equity charge would thus likely do little to improve the risk assessment and would lead to the perverse result of lower risk charges if the equity position of the affiliated entities were to deteriorate over time. Indeed, a flat BACV would create significant disincentives for a group to maintain robust equity levels in non-insurance affiliates within the group, which is clearly the opposite of the result that the NAIC is seeking to achieve.

In determining how to assess the risk of non-insurance entities, the Working Group must first address the appropriate scope of the group as a threshold issue. We believe that groups should be permitted to exclude non-financial/insurance affiliates held outside of the regulated insurance entities which are not highly interconnected and do not expose the insurers or the holding company to material financial or operational risk. Factors that could be considered for determining the appropriateness of excluding non-financial affiliates could include:

- Existence of corporate guarantees, intercompany indebtedness and other financial links;
- Relative Importance to the ultimate holding company of the overall group based on size thresholds, such as excluding entities that account for 10% of the non-financial revenue or assets of the overall group;
- Operational interdependence, including the existence of shared resources such as IT platforms, treasury operations and office facilities; and
- Materiality to the application of credit rating methodologies to the overall group rating.

We understand that the IAIS has suggested that reputational risk should also be considered in determining the scope of a group. In our view, reputational risk should not be considered in the determining the scope of the group. If it were to be included as a factor, reputational risk should only be considered to the extent that the potential reputational damage would be likely to have a material adverse impact on (i) the ability of insurance group to conduct its business in the ordinary course, (ii) the group’s credit rating; or (iii) its access to the capital markets.
We would then recommend that the NAIC develop risk charges that are focused on the actual risk drivers that arise from group interconnectedness, such as capital charges based on the level of corporate guarantees and operational risk charges that address vulnerabilities such as shared corporate resources and IT platforms.

**Question 2:** If the Working Group decides that a flat charge should be applied to an entity’s BACV, is the current RBC charge of 22.5% appropriate? If the answer is no, what should the charge be and why do you believe that charge is appropriate?

If the entity is owned by an insurer, then using the current 22.5% charge is consistent with the concept of RBC aggregation (using current jurisdictional standards). If the entity is not owned by an insurer, then the 22.5% charge is not appropriate as discussed above.

**Question 3:** Do you believe that use of a hybrid approach is appropriate? If the answer is yes, what data should be collected and how can that be used in determining a more risk-focused approach?

We do not favor a hybrid approach such as the one mentioned here, in which the current 22.5% factor would be used at the outset and we would “get it right later”. Implementing a non-risk sensitive approach without the benefit of substantial field testing would create a significant risk to the credibility of the NAIC group aggregation approach, especially when NAIC staff has already discussed the some of the shortcomings of the approach. Moreover, although this is only intended to be a regulatory tool, insurance groups will inevitably be required to disclose the admittedly flawed NAIC group capital tool results to their non-US regulators, rating agencies and, possibly to, investors. This could result in potential adverse consequences due to a potentially inflated capital outcome that does not reflect an accurate portrait of the group’s risk, or even mislead investors and non-US regulators if certain risks are understated.

**Treatment of Non-Insurance Entities that are Subject to Capital Requirements**

**Question 4:** Which approach is more appropriate for non-insurance entities that are subject to capital requirements: the entity’s current sectoral capital requirement or a flat equity charge? Why do you feel that approach is more appropriate?

As the memo points out, using existing sectoral requirements is more risk-sensitive than a flat 22.5% charge, and is consistent with the concept of aggregating existing jurisdictional and sectoral capital resources and capital requirements. Applying the flat 22.5% affiliates charge would be in essence applying legal-entity insurance RBC to regulated non-insurers and the rest of the group when calculating a group capital assessment. The sectoral capital requirement approach is preferable. The NAIC has repeatedly asserted that other sector regulators should be deferring to the NAIC and state regulators’ insurance regulatory expertise. If the NAIC expects other sector regulators to defer to the state insurance regulatory expertise, it must be prepared to offer similar deference to the expertise of banking and security regulators.

**Question 5:** If the Working Group decides that a flat charge should be used for these regulated entities, is the current RBC charge of 22.5% appropriate? If the answer is no, what should the charge be and why do you believe that charge is appropriate?

Any flat charge here is going to be very difficult to support with data. It will not be risk-sensitive, and will not be appropriate.

**Use of Scalars for Non-U.S. Insurers**

**Question 6:** Is analyzing financial information from non-U.S. insurers an appropriate approach to developing country-specific scalars? If the answer is yes, what specific financial information should
be obtained and analyzed in developing the scalar? If the answer is no, what approach do you prefer and why is that approach more appropriate?

For the time being, PCI supports the previous suggestion of NAIC staff that the scalars be set at 1.0 (applying no adjustment to the capital resources and required capital for non-U.S. insurers within a group).

**Question 7:** If the Working Group elects to base development of country-specific scalars on financial information, should this information be collected over a number of years or should a data call be performed to collect this information now?

The required information should be collected over a period of years. An immediate data call is unnecessary.

**Question 8:** If the data is collected over a number of years, what approach to these entities should be taken in the interim? Two possible options include the current RBC flat charge for the entity or the entity’s non-scaled capital requirements.

As we state in the answer to question 6, the entity’s non-scaled capital requirements should be used.

**Scope**

**Question 9:** Some of the above questions and related responses may be impacted by the chosen scope of the group for purposes of the group capital calculation. Please provide any comments, along with the related rationale, on the appropriate level for establishing the scope of the group for purposes of an analytical tool.

There are at least two levels of scope questions:

1) **Size threshold** – Given the complexity that even a seemingly simple group capital calculation involves, it is probably not appropriate to apply the GCC to the smallest U.S. groups. Our preliminary thought is that the ORSA threshold ($1B annual group-wide US premium) is probably an appropriate threshold for the GCC as well. If a group is large and complex enough for the ORSA requirement to apply, it is probably appropriate for the GCC to apply as well. In any case we do not believe the threshold should be any lower.

   Another potential threshold is to apply the GCC only to internationally active insurance groups (IAIGs) under the IAIS’ ComFrame criteria ($10B annual global premium or $50B assets/writes business in 3 or more countries/10% of all premium outside home country).

2) **Groups with non-U.S. group-wide supervisor** – Only one group capital calculation or requirement should apply to any particular insurance group. Therefore, if a group with a non-U.S. group-wide supervisor is subject to a group capital requirement imposed by its group-wide supervisor, the NAIC should not attempt to apply the GCC to this group. Applying multiple capital requirements to the same group or sub-parts of that group would be confusing, costly and hamper appropriate and efficient group-wide supervision. We would also anticipate that, should a state regulator need group-wide information regarding such a group, that request should be handled through the supervisory college process.

If you, other members of the Working Group or NAIC staff have any questions about our comments, please contact me at your convenience. We will work with you to produce a group capital calculation that state regulators can use to enhance the strong U.S. state-based regulatory system.

Sincerely,

Stephen W. Broadie